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SUBJECT: Tax Reform: GoB Passes Its Latest Legislative Test

1. SUMMARY: Lula's administration has recorded its latest key legislative win, with the Chamber of Deputies' 378-53 approval of the GoB tax-reform bill on September 4. In so doing, the GoB was compelled to make some relatively minor extra concessions to Brazil's governors. All observers predict the bill will undergo further major re-working in the Senate; there is little hope for final passage before mid-November at best. The GoB may consider detaching and submitting separately the bill's two elements that it wants approved by October: extension of the "temporary" CPMF levy and of the 'DRU' (long-standing federal-government authority to de-link 20 percent of its revenues from required earmarks.) END SUMMARY.

2. The September 4 vote was the first of the Chamber's two required floor votes on the tax-reform bill. Dozens of amendments remain to be voted on to complete the first-round process, which should be finalized by the middle of the week of September 8. Thereafter, five Chamber sessions with a quorum must take place before the second-round vote may occur. Thus, that vote could occur in the September 17-24 timeframe. Provided the bill gets the necessary three-fifths majority again, it will proceed to the Senate Justice Committee for routine determination of its constitutionality, and thence to the Senate floor for the required pair of plenary votes there. A notional timetable in the September 5 'Estado de Sao Paulo' forecast the Senate committee reporting out the bill in late October, and the second-round Senate floor vote occurring in mid-November.

3. The Chamber floor vote came at 3 a.m. September 4, in an extraordinary session convened by Speaker Cunha, after sixteen hours of turbulent negotiations. The GoB had been adamant about holding a vote in the Chamber's September 3 session and hoped to pass the bill quickly that afternoon. But resistance from governors -- particularly Aecio Neves (PSDB-Minas Gerais) -- raised the prospect of the GoB's losing the vote outright, and impelled Lula's team to make further concessions to the governors. These negotiations delayed the voting until the early hours of Thursday, at which point the GoB submitted its revised bill. With the governors' and mayors' backing, that bill passed with an impressive 70 votes to spare.

4. GoB leaders immediately pointed out that the final result had featured near-impeccable voting discipline throughout the government's alliance base. In fact, the PT-led coalition, even without any opposition support, delivered more than enough votes to pass the bill, suggesting that the government's late-night courting of the powerful PSDB governors had been unnecessary. This vote thus contrasted favorably with the pension-reform bill's key recent victory in the Chamber, which would not have been won without votes of parties outside the GoB coalition. Moreover, the solid support this time from the PMDB party (70 of 77 PMDB deputies supported Lula's bill) is seen as proof that Lula's intensified courtship of the PMDB has borne fruit. The opposition PSDB party vote split down the middle (24 yea, 26 nay), while PFL deputies opposed en masse and walked out when they saw they were going to lose.

5. The GoB's last-minute concessions to the governors consisted of: adding a further billion Reals (for a total of 6.7 billion) to the fund for compensating states' revenue losses on exports due to the Kandir law; adding two billion Reals (making a total of eight billion) to the prospective new compensation mechanism for ensuring states against revenue decreases arising from the eventual reform of the ICMS tax; and ceding to governors the control over resources from the new regional development fund already promised as part of the same tax reform. Numerous 'retail' deals with individual states were evidently also made, notably with Rio state after Finance Minister Palocci met with Rio governor Rosinha Mattheus.

6. The GoB had previously agreed to concede one-quarter (approximately 2.2 billion Reals annually) of Brazil's national CIDE (fuel) tax to states and municipalities. But it has held firm in its rejection of governors' demands for

a comparable share of the CPMF (financial transactions) levy, which totals over twenty billion Reals annually.

17. Other main elements of the tax-reform bill were left unaffected by the last-minute September 4 horse-trading. Chief amongst these:

-- The ICMS tax is to be phased into a national, VAT-like tax with five basic rates, imposed at point of sale rather than of production. Transitional time-frame, mechanisms for defining rates and categories, and limits or ceilings to the rates, remain almost entirely undefined;

-- To do away with Brazil's 'fiscal wars,' whereby states use tax lures for new industry, all fiscal incentives of this type are supposed to discontinue after September 30;

-- New tax relief on capital goods;

-- Introduction of a progressive inheritance-tax rate (up to a maximum of 15%, vs. the present uniform four percent.)

18. The bill contains two other main elements central to GoB fiscal authority: the extension after December 31 of Brazil's 'temporary' CPMF (financial services levy) and of the 'DRU' (a mechanism giving the GoB freedom to allocate twenty percent of its tax revenues away from earmarked purposes.) By most traditional juridical interpretation, if Congress does not by September 30 approve these extensions, the GoB's authority in both areas will lapse on January 1, 2004. Precedent suggests that the GoB would find some way round this supposed constitutional constraint, but a growing number of voices is urging that it detach and submit separately for early passage this component of its tax-reform bill.

19. COMMENT: The Chamber's approval of the tax-reform bill preserves the legislative momentum of Lula's fiscal reforms. With respect to substantive content, however, that bill has become decidedly under-whelming. Enthusiasm for it has waned in the private-sector and perhaps especially amongst the ranks of Brazil's governors and mayors (Septel). A common assumption now is that its main result may be just a further increase in Brazil's tax burden. The near-universal forecast is that it is liable to undergo major further recasting before final passage through the Chamber -- let alone when it reaches the Senate, where over twenty sitting members are former governors.

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